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Key Person Insurance – Buy/Sell Agreements

With both farm partnership and equity partnerships in the agricultural sector, it is important to consider the need for key person insurance and buy/sell agreements.

Key person insurance is essentially a life insurance policy taken out over a key shareholder in a company or partner in a partnership. The purpose of key person insurance is to insulate the company or partnership against disruption that may occur in the event of death or permanent disability of the key person. It can also be used to put the surviving shareholder or partner in a position to purchase the deceased or permanently disabled shareholding in the company or partnership interest (or as the case may be).

How does it work?

Take the example of a father and son farming partnership which owns the stock and plant in a farm, or alternatively two equity partners in an orchard or vineyard, each partner would take out a life insurance policy on the other partner. The beneficiary under the policy will be the other partner who receives the funds in the event of death or permanent disability of the other shareholder or partner. The insurance funds can then be used to purchase the deceased or permanently disabled shares in the company or interest in the partnership, together with any current account owing. It is important not to overlook the current accounts, as this can often be a significant figure to factor in.

To ensure that the insurance proceeds are used for the intended purpose of purchasing the deceased or permanently disabled partner’s interest in the company or partnership, the shareholders/partners often agree that the insurance policies will be held by an independent trustee.

In addition to obtaining insurance advice from an appropriate life insurance broker, it is also necessary to get legal advice in respect of an appropriate buy/sell agreement which sets out the legal mechanics of the application of the insurance proceeds and sale and purchase of the shares in the company or interest in the partnership.

Buy/sell agreement

In the absence of a buy/sell agreement, the interest in the shares in the company or partnership will typically fall to the estate of the surviving partner/shareholder. In the case of a partnership, the partnership will likely dissolve on the death or permanent disability leaving the survivor to buyout the assets. The executors and trustees may not have any obligation to sell the shareholding in the company or partnership assets to the survivor, leaving the survivor to deal directly with the family. A buy/sell agreement is designed to address these issues and will typically provide:

- that each party will take out an insurance policy on the other party to the value of their interest in the partnership or shares in the company or partnership interest (plus current accounts);
- that the policies will be transferred and held by an independent trustee;
- that in the event of death or permanent disability of one party, that party’s shares (and current accounts) must be sold to the surviving party at an agreed value; and
- if no value has been agreed or the valued recently updated, then at fair value.

A buy/sell agreement will often provide a process to deal with a situation where the insurance proceeds exceed the value required or are insufficient. In the event that the proceeds are insufficient, arrangements

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can be made for loan with the balance to be paid off over time.

Typically the premiums on the insurance policies are paid for by the company or partnership and debited to the relevant shareholder's current account (i.e. the shareholder or partner that owns the policy). Where there are differences in insurance costs, the premiums are often equalised on a prorate basis (i.e. paid 50/50 notwithstanding that one life maybe more expensive than the other given age and health).

Concluding comment

The loss of a co-shareholder in a tightly held company or business partner is often overlooked as a risk. However, having robust key person insurance policies and well drafted buy/sell agreements can be a very useful tool in insulating against these risks and ensuring that the surviving shareholder/partner is in a position to buy out the deceased or permanently disabled shareholder’s/partners interest. This also, of course, ensures that the deceased or permanently disabled person’s family receives fair value for his or her interest. This is doubly important with closely held companies or partnerships as it is often difficult to sell the interest to an outside third party in the event that the surviving shareholder or partner does not have the resources to purchase the interest or shares.

Lastly, it is worth noting that as key person insurance obviously relates to the business owner who is not retired, typically in the 40 to 65 age range and as such can be more affordable than many may think.

Want to know more?

If you have any questions about key person insurance of buy/sell agreements, please contact our specialist rural and agribusiness team.